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AUTHOR Hovey, Hal
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ABSTRACT

This paper discusses the current role of the property tax as a revenue source for state and local governments. It is written for state and local policymakers and others interested in property taxes, including those who lack an indepth knowledge of tax systems. The purposes of the paper are to: (1) explain the current role of property taxes in financing government and how the current situation developed; (2) acquaint the reader with the general arguments for and against heavy reliance on property taxes in financing governments; (3) assess the concerns about property taxes that bring the idea of reducing them to the state policy agenda; (4) analyze the other concerns that have caused property taxes to continue to be a mainstay of state-local finance; (5) summarize what has been happening recently on this issue in the states; and (6) offer suggestions on appropriate state policies for dealing with property tax issues. The paper identifies six states that are the most serious candidates for property tax reform--Illinois, Iowa, Maine, Minnesota, Nebraska, and Wisconsin. Two conclusions follow from the state-by-state analysis. First, there are some good reasons why officials of most states are not cutting property taxes; and second, state officials should not worry much about missing out on a wave of state-financed property tax reductions sweeping the country. Four tables are included. Appendices contain a summary of interactions between business and property tax issues and suggestions for state decision makers who dislike taxes but recognize that maintaining approximately the current level of revenues is a necessary evil: defend local tax bases; dramatize your concern about proposals to create new loopholes by insisting on common-sense safeguards; do not get sucked into discussions of tax policy when the issue is spending; seize opportunities to broaden the tax base; and do not try for consensus if you really favor tax reform. Information about the Finance Project and its publications is included. (LMI)

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THE PROPERTY TAX IN THE 21st CENTURY

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THE PROPERTY TAX IN THE 21st CENTURY

May 1996

By Hal Hovey

Prepared for
THE FINANCE PROJECT
1341 G Street, NW
Washington, DC 20005
202-628-4200
Fax: 202-628-4205

THE FINANCE PROJECT

ABOUT THE AUTHOR

Hal Hovey is the President of State Policy Research, Inc. and the editor of its primary publications, State Policy Reports and State Budget & Tax News.

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PREFACE

Public financing for education and an array of other children's services has become a topic of significant interest and political concern. Growing skepticism among a critical mass of American voters and taxpayers has fueled doubts about the ability of government to solve social problems and provide basic supports and services that enhance the quality of life in their communities. Voters spoke clearly in November 1994. They want more for their money. They want more and better services, but they also want balanced budgets and cuts in income and property taxes. In this time of big public deficits, they want government at all levels to operate more effectively and efficiently. They also want it to invest wisely and live within its means. On Capitol Hill on Washington, DC and in statehouses nationwide, policymakers are scrambling to respond.

Across the country, there is mounting evidence of efforts to reform and restructure education and other community supports and services in order to improve the lives and future prospects of children and their families. Critical to the success of these initiatives is the way in which they are financed. How revenues are generated and how funds are channeled to schools, human service agencies, and community development initiatives influence what programs and services are available. It determines how they are provided and who benefits from them. Financing also affects how state and local officials define investment and program priorities, and it creates incentives that guide how educators, other service providers, and community volunteers do their jobs. For these reasons, financing fundamentally affects how responsive programs and institutions are to the needs of the people and communities they are in business to serve.

In recent years, several blue ribbon commissions and national task forces have presented ambitious prescriptions for reforming and restructuring the nation's education, health, and human service systems in order to improve outcomes for children. While some have argued that public financing and related structural and administrative issues are critical to efforts to foster children's healthy development and school success, none has been framed for the specific purpose of inventively reconceptualizing public financing. Indeed, many of the most thorough and thoughtful reports have called for an overlay of new funds, but have neglected to provide cogent analyses of effective financing strategies, the costs of converting to these approaches, and the potential beneficial outcomes that might accrue from addressing financing reform as an integral aspect of program reform.

In addition, the past several years have witnessed a burgeoning of experimental efforts by mayors and city managers, governors and state agency directors, legislators and council members, program managers and school officials to make government work better and more efficiently. They have been enhanced by the work of people outside of government, including foundation executives, business and labor leaders, community organizers, and academic scholars. Some are creating new ways to raise revenues, manage schools, deliver human services, and spur community economic development. Others are designing new public governance and budgeting systems. Still others are developing and testing new approaches to more directly involve citizens in setting public priorities and maintaining

accountability for public expenditures. Taken together, these efforts suggest the nascent strands of new and improved public financing strategies.

Against this backdrop, a consortium of national foundations established The Finance Project to improve the effectiveness, efficiency, and equity of public financing for education and an array of other community supports and services for children and their families. Over a three-year period that began in January 1994, The Finance Project is conducting an ambitious agenda of policy research and development activities, as well as policymaker forums and public education. The aim is to increase knowledge and strengthen the capability of governments at all levels to implement strategies for generating and investing public resources that more closely match public priorities and more effectively support improved education and community systems.

As a part of its work, The Finance Project produces a series of working papers on salient issues related to financing for education and other children's services. Some are developed by project staff; others are the products of efforts by outside researchers and analysts. Many are works in progress that will be revised and updated as new information becomes available. They reflect the views and interpretations of the authors. By making them available to a wider audience our intent is to stimulate new thinking and induce a variety of public jurisdictions, private organizations, and individuals to examine the ideas and findings they present and use them to advance their own efforts to improve public financing strategies.

This paper, *The Property Tax in the 21st Century* by Hal Hovey discusses the current role of the property tax as a revenue source for state and local governments. It is written for state and local policymakers and others interested in property taxes, including those who do not have an in depth knowledge of tax systems. It lays out the general arguments for and against heavy reliance on the property tax as a revenue source and concludes with discussions of recent state actions and recommendations for the appropriate state role in dealing with the property tax. The paper was originally prepared for the conference on *Property Tax Reform: Can It Work?* sponsored jointly by The Finance Project and the National Conference of State Legislatures in October 1995.

Cheryl D. Hayes
Executive Director

INTRODUCTION: HOW POPULAR IS PROPERTY TAX RELIEF?

Relieving property tax burdens is one of the most popular ideas in state fiscal policies in the mid-1990s. After Michigan's widely publicized relief was approved by voters in 1994, many state elected officials have embraced the idea of eliminating, or at least reducing, major portions of the property tax—such as residential property taxes or school property taxes. Some legislatures, particularly those in South Carolina and Wisconsin, enacted major reductions in 1995. Many states have studies under way to lead to what is expected to be intensive activity on this front in the legislative sessions of 1996.

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By the most up-to-date estimates available, covering the 12 months ending in the April-June quarter of this year, state and local revenues from property taxes increased faster than revenues from either of the other two major taxes, those on sales and personal income.

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Contradictory Views Of Property Taxes

Both of these statements are true. State elected officials are talking a lot about property tax relief. If nationwide statistics on state tax discussions were kept, they would probably show that property tax relief is mentioned more than sales or personal income tax relief by a wide margin. But as property tax relief is discussed more often, state and local officials are continuing to rely on more rapid increases in property taxes than other taxes.

This contradiction between what elected officials are saying and what they are doing leads to a cynical, but incorrect, explanation: that politicians are saying one thing and doing another. Put another way, the cynical view is that state elected officials are saying what they think the public wants to hear, but doing what those elected officials want to do, without regard for what the public thinks or what the same elected officials are promising.

This cynical view is not correct, but the contradiction between apparent tax policy priorities and actual tax policy is quite real. It is likely to continue. Furthermore, there are strong reasons for it to continue—reasons that include good public administration, good economics, and good tax policy, as well as good politics. But there are also strong arguments for why the contradiction should end—why property taxes should play a smaller role in financing state and local governments.

What This Paper Does

The purpose of this paper is to: (1) explain the current role of property taxes in financing government and how the situation came to be what it is today; (2) acquaint the reader with the general arguments for and against heavy reliance on property taxes in financing governments; (3) assess the concerns about property taxes that bring the idea of reducing them to the state policy agenda; (4) analyze the other concerns that have caused property

taxes to continue to be a mainstay of state-local finance; (5) summarize what has been happening recently on this issue in the states; and (6) provide the author's personal suggestions on appropriate state policies for dealing with property tax issues.

The primary focus of this paper is on property taxes on housing—both those paid by owner occupants and those levied on owners of rental property. The often different considerations that apply to possible changes in taxation of business property are discussed in Attachment A.

THE ROLE AND USEFULNESS OF THE PROPERTY TAX

Historic Origins

The property tax has a truly venerable history[1] Even before there was money, early leaders extracted payments from citizens from levies based on property in the form of harvests and livestock. In the 4th century BC, the Roman Empire paid its soldiers by a tax on capital assets, called a *tributum*, from which the terms *pay tribute* and *contribute* are presumably derived. Ancient governments also kept title to many of their lands and collected revenue for their use based on the value of production on them, a practice that still accounts for a substantial part of Alaskan revenues today and for substantial revenues from federal lands that are an important source of state and local revenue in some Western states today. While not technically a property tax, this practice has similar economic effects.

Until the Industrial Revolution, most wealth took the form of agricultural land holdings, so most taxes were direct or indirect levies on this wealth. Because money transactions—such as cash wages, dividends, and interest—were unimportant by modern standards, property and property-related measures had to be a major basis for taxes, rather than the more modern bases of sales and wages and salaries.

Evolution In The United States

As the property tax system evolved in the United States, it adhered to the concept that all property was taxable. New categories of property were taxed as they evolved, with new names to fit the increasingly important forms of property. As substantial values developed in things other than land and buildings, the taxes were applied to *personal property*, as distinct from *real property*. As financial instruments such as stocks, bonds, and bank deposits became important, these were taxed also as *intangible personal property*, or *intangibles* for short. As households began to acquire personal property of value, such as cars and boats, the property tax was levied on them. The term *business personal property* was developed to distinguish these household taxes from taxes on tangible personal property used in business, such as inventories, machinery, and equipment.

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[1] For a comprehensive history of all taxation, see Carolyn Webber and Aaron Wildavsky, A History of Taxation And Expenditure In The Western World (Simon and Schuster, 1986). The historical examples cited here are from this volume, particularly pp. 108-109.

Until the Great Depression of 1929, property taxes were the mainstay of all government finance. The federal and state governments were fiscally much less significant than they are today, and local governments relied mainly on property taxes. Then the Depression triggered widespread use of the sales tax, and the federal government expanded by primarily taxing incomes and payrolls. State governments increased their use of sales taxes, and most of them taxed personal and corporate income as well.

Recent History

The resulting evolution of the importance of the property tax is shown in the following table.[2] It shows both the revenues from each of the three major state and local taxes, and the proportion of their total revenue raised by each tax for selected years from 1965 to the most recent data (second quarter of 1995, at seasonally adjusted annual rates).

Relative Importance of "Big Three" State and Local Taxes, CY 1965-CY 1995II

	1965	1975	1985	1990	1992	1994	1995II
Total Revenue ($ billion)							
Personal Income Taxes	4.4	22.5	72.1	106.0	116.7	131.5	136.7
Sales Taxes	18.2	51.7	131.1	183.5	200.8	226.2	235.4
Property Taxes	23.2	53.4	107.0	155.4	177.7	190.8	199.5
Total	45.8	127.6	310.2	444.9	495.2	548.5	571.6
Percentage of Total							
Personal Income Taxes	9.6	17.6	23.2	23.8	23.6	24.0	23.9
Sales Taxes	39.7	40.5	42.3	41.2	40.5	41.2	41.2
Property Taxes	50.7	41.8	34.5	34.9	35.9	34.8	34.9
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

The table shows that the role of property taxes in state and local finances continued its historical decline through roughly 1985, dropping from providing over half of state and local revenue from the three major taxes in 1965 to just over a third in 1985. This was a period of major expansion of state fiscal roles, particularly in education. As states moved to cover a larger share of public school costs, the tax support of schools shifted from local property taxes

[2] The table reflects state and local taxes as they are reported in the national income and product accounts. There are minor conceptual differences between these data and those reported in the Census Bureau publications on governmental finances. Those data are available only through FY 1992. The table draws historical data from the Advisory Commission on Intergovernmental Relations' Significant Features Of Fiscal Federalism, Vol. 2, p. 26, and the CY 1994 and CY 1995 second quarter data from the Survey Of Current Business (August 1995, p. 16).

to state income and sales taxes. Also during this period, many states began to allow local governments to use local option sales and/or income taxes, rather than relying solely on property taxes as their major revenue source.

The table also shows that the shift away from the property tax stopped about 1985. Property taxes now provide a slightly larger share of state and local than they did in 1985.

THE PROPERTY TAX IN PUBLIC FINANCE 101

Alternative Tax Bases

In modern times in the United States and other countries, governments have examined taxing just about everything. The alternatives boil down to three different bases for taxing individuals (economists like to think of the taxpaying unit as "households"), as distinct from firms. The three major bases for taxation are:

1) **Consumption**: Such taxes measure ability to pay based on what households consume, not what they own, save, produce, or are paid as salaries for their work, nor what they are paid for their investments such as interest, rent, and dividends. The European value added tax and the proposed U.S. "consumption tax" are national examples. The sales tax is the primary state example, but there are also excise taxes on particular forms of consumption such as of tobacco and alcoholic beverages, amusements, gasoline, lodging, and restaurant meals.
2) **Income**: Such taxes measure ability to pay on the basis of the current flow of purchasing power to households, including income from wages and all forms of investment income such as rents and royalties, dividends and interest, and capital gains. The tax base ignores relative wealth and gives no credit for saving and investing, rather than spending on consumption.
3) **Wealth**: Such taxes measure ability to pay based on current wealth, no matter how or when it was acquired, without consideration of either current consumption or income. The primary example is the property tax, but estate and inheritance taxes also reach this tax base.

Objections To Each Choice Of What To Tax

The primary argument against each of these tax bases is that it ignores ability to pay based on the other two dimensions. The property tax is criticized as unfair because it can appear confiscatory on people with low incomes and relatively high property wealth, such as low-income pensioners with valuable homes and farmers with valuable land but low incomes in a particular year. The income tax is criticized because some rich people and corporations sometimes do not have any taxable income and pay no tax. Sales taxes are criticized as unfair because they impose their highest burdens (in relation to income and wealth) on the poor.

To respond to these criticisms, many governments have hybrid provisions that assess taxes on one dimension of ability to pay, but then abate or increase the tax by ability to pay measured on another dimension. Some examples are: (1) household property taxes based on wealth but abated by circuit-breaker credits based on low incomes; (2) income taxes which

give sales and property tax credits based on apparently excessive burdens of those taxes relative to income; and (3) corporate income taxes which respond to the criticism that wealthy companies could pay no tax by alternative calculations based on net worth, as found in many state corporate income tax laws.

All Taxes Are Bad

No one likes taxes—not legislators, not governors, not local officials, not taxpayers, and not even economists. With minor exceptions,[3] all taxes are *per se* undesirable. Taxes take purchasing power out of the hands of individual consumers, who are better than anybody at deciding how best to use their purchasing power to meet their individual needs. All taxes distort economic incentives, and the higher the tax, the bigger the distortion. Taxes create economic deadweight losses associated with the socially unproductive efforts to keep records for tax collectors, pay the tax collectors, and contrive ways to minimize tax liability that inherently create economic distortions. Taxes are the symbol of coercion over individual choice, of the triumph of bureaucrats over people, and of the partial socialization of our economy.

All taxes are unpopular for these good reasons. So the constant search by elected officials for a popular tax plan is bound to fail.

The practical implications for legislators and others making decisions about appropriate property taxes are these: First, criticism of property taxes and all other taxes is inevitable, because all taxes are bad, considered independent of the spending they finance. Second, property taxes and all other taxes measure ability to pay based on one dimension, and are inherently unfair when ability to pay is considered on the other dimensions.

These disadvantages come with the territory of taxes. They are inherent in public decisions to spend money. But they do not make property taxes any worse or any better than any other tax because all taxes are subject to the same criticisms.

WHY NEARLY EVERYBODY HATES THE PROPERTY TAX

The Least Popular State And Local Tax

Public opinion polls[4] consistently show property taxes to be the least popular form of state and local revenue-raising measures. There is not much in-depth polling on why, but observers agree on the reasons, though not their relative importance. Some of the reasons are:

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[3] Both citizens and experts sometimes find taxes they like when the primary purpose of the tax is to regulate conduct through economic incentives rather than outright prohibitions. Taxes on the consumption of tobacco, alcoholic beverages, and pollution from industrial processes are examples.

[4] In addition to many polls in individual states, the Advisory Commission on Intergovernmental Relations has a long-standing poll that asks a national sample to identify the least fair tax. Among major state and local taxes, property taxes consistently win the honor of being judged the least fair.

- Property taxes are noticed more by taxpayers per dollar raised. They are paid in lump sums, usually twice a year, by taxpayers who write checks for them or see the costs in their mortgage payments.[5] Contrast this with sales taxes, paid painlessly as part of the cost of a purchase, and income taxes withheld from wages and salaries.
- Many voters believe that property taxes are unfairly administered. Who can blame them? In most states their assessed value bears no apparent relationship to what they know is the value of the property; neighbors and friends often have comparable properties but much different property taxes; and stories of people who get special breaks from assessors or state law are common. Contrast this with sales taxes which are known to be uniform, and state and local income taxes, which (unlike federal income taxes) are generally considered hard for anyone to avoid.
- Voters correctly perceive that property taxes have no relationship to income, so that middle-class neighbors, struggling families and retired couples, and affluent neighbors all pay about the same.
- Taxpayers recognize they are being taxed on "value" that is not necessarily applicable to their situation, particularly if they own a family farm or an older house in what real estate people would call a "hot" neighborhood.
- Many voters are aware of apparently capricious differences in property taxes that depend on the municipality and school district where they happen to live.
- To those who think about it, as many elderly do, it seems wrong that government will literally kick them out of their own home if they do not pay. It is easier to understand how the tax collector might want a piece of what they spend and a piece of what they earn.

Business property taxes are another matter (see Attachment A on business and the property tax), but some of the business concerns are about the same as those of households. Businesses, from manufacturing to barber shops, are particularly upset when they pay much higher property taxes than their competitors in other states or communities in the same state.

Target Of Opportunity

Lots of people think government is too big, that it is too powerful, that it spends too much, and that it taxes too much. If someone wants to make governments spend less, it makes sense to attack taxes, not spending, because taxes are less popular than spending. From this perspective, it makes sense to attack all taxes, but to concentrate particular attention on the softest target: the least popular tax—which is the property tax.

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[5] Older middle-income persons vote in disproportionate numbers to younger and lower-income persons who do not see explicit property tax bills because they are renters. Among voters—particularly those who vote for "lesser" offices such as state legislators—property ownership is disproportionately high, as is holding property without mortgages, so large numbers of voters who count are writing checks for thousands of dollars twice a year.

So property taxes are often complained about for reasons that have nothing to do with tax policy. That is, substituting a "better tax" for the property tax to raise equal revenues won't end the complaints. To the extent the complaints are based on opposition to the size and scope of government, the complaints will continue. With no property tax to attack, these complaints would center on the least popular of the remaining taxes.

Objections From Tax Spenders

Because people do not like property taxes, two other significant groups do not like them either.

Local officials do not like them. First, local officials have to take the heat for their cost and any increases in them. They would understandably like to have the money from state capitols or Washington so that legislators, governors, Members of Congress, and the President take the heat for raising it. Second, given a choice, (which many of them are not given by their states), many local officials would rather raise money in other ways—through sales taxes, local income taxes, excise taxes, and fees—just about any way but the property tax.

School employees, particularly teachers, do not get as much taxpayer money as they would like. As they see it, much of the problem is that they are stuck with the wrong tax source (the unpopular tax) and the wrong rules (in many states, having to go to voters for increases). They would prefer easier ways to raise money, such as getting it from a higher level of government. If they must raise money locally, they would like other options on what to tax and fewer opportunities for voters to reject tax increases. These perspectives are shared by other less vocal groups interested in public spending.

Adding It Up

Putting all the opposition together, state officials find property taxes are opposed by: (1) the public generally; (2) depending on states and circumstances, major groups of voters such as farmers, large business, small business, the elderly, and citizens in local areas with particularly high property taxes; (3) local officials; (4) the citizens who are most opposed to government spending; and (5) the citizens who are most supportive of government spending. Against this formidable array stand the leaders and members of "Citizens To Increase Reliance On Property Taxes," with a membership of zero.

It is no surprise, then, that most state elected officials favor reducing property taxes. It is no surprise that many legislators and governors have made proposals to reduce property taxes. It is no surprise that every reasonably diligent state elected official is interested in considering proposals for reducing property taxes, including any suggested in their own state and any adopted or even seriously considered in other states.

WHY NEARLY EVERYBODY LOVES THE PROPERTY TAX

The substantive case for reducing or eliminating property taxes is strong. The political forces for this change are apparently overwhelming. The announced position of most elected officials is that property taxes should be curtailed. But property tax revenues are growing

proportional to the growth in state and local revenue-raising, with a slightly increased dependence on property taxes appearing over both the past decade and the past year. Something here does not make sense. The explanation must lie in some unnoticed but powerful force such as fate, God or the gods, or a Murphy's law of tax policy which holds that the least popular tax will be increased the most.

Expert Opinion

One possible explanation is that when elected officials commission blue-ribbon commissions, consultants, and even their own staffs to examine reducing property taxes, they almost always receive a recommendation that they cool their ardor for reducing or eliminating property taxes. Politically, expert opinion is more an annoyance than a force to be reckoned with, but warnings from experts do seem to have cut the zeal and certainty with which elected officials have approached reducing property taxes.

These opinions are not new. For example, surveys in 1934 and 1994 asked a cross-section of academic economists, "Should there be retention of property tax as a major source of local revenue?" About 85 percent answered "yes" one year ago and six decades ago.[6]

Bases For Experts' Preferences

Experts usually start with the reminder that the relevant question is not whether property taxes are bad, but whether property taxes are less bad or even worse than the other taxes available. To guide this inquiry for state policy, they discuss criteria to decide which taxes are less bad than others. These criteria[7] and how property taxes stack up on each,[8] are:

- ***Ability to raise revenue consistently in good times and bad, and to grow roughly in line with population and inflation.*** Property taxes do this well, providing revenues that do not fluctuate as much as sales or income tax revenues during

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[6] Joel Slemrod, "Professional Opinions About Tax Policy: 1994 And 1934," National Tax Journal (March 1995).

[7] The criteria were distilled by the author from a review of practically all of the major state tax study reports prepared from 1980 to 1992. They appear in summary form as Chapter 3, "Keys To A Quality Tax System," in Financing State Government In The 1990s [(NCSL) and National Governors' Association, 1993]. For an earlier example of criteria acceptable to state legislators, see "Principles Of A High-Quality State Revenue System." This statement, developed by a group of legislators and staff in the 1980s, appears in the National Conference of State Legislatures publication The Unfinished Agenda For State Tax Reform (1988).

[8] Experts will recognize that academics argue about each of the points listed as characteristics of the property tax. For a richer discussion of the conventional wisdom than provided in this paper, see standard public finance textbooks (all issued with various editions in various years): Richard A. Musgrave and Peggy B. Musgrave, Public Finance In Theory And Practice (McGraw Hill), Bernard P Herber, Modern Public Finance (Irwin), and Harvey S. Rosen, Public Finance (Irwin). The main caveat is that they apply to the typical broad-based property tax. States can defeat, and some have defeated, some of these characteristics by property tax design. For example, a tax with a Proposition 13-type cap on growth in assessed value, as California has, will not match the growth of inflation in times of high inflation. Conversely, property taxes with large fixed-dollar homestead exemptions, as Florida and Louisiana have, will grow faster than inflation in such times.

business cycles. Unlike alternative taxes, property taxes can be administered so that a jurisdiction's revenue is accurately known before a fiscal year begins.

- ***Equitable distribution of tax burdens.*** By definition, broad-based property taxes distribute tax burdens in proportion to ability to pay as measured by wealth, though not as measured by consumption or income. Contrary to widely held beliefs, they probably are not regressive. Even if they are regressive, they are not as regressive as the typical state sales tax.[9]
- ***Minimal distortion of economic activity and minimal discouragement of economic growth.*** Because all taxes fail this criterion, one key is having a broad definition of tax bases and a mix of taxes—including those based on sales (consumption), income, and wealth—so that low rates can be maintained for each type of tax.
- ***Easily administered.*** The property tax is almost impossible to avoid and easy to collect, compared with its alternatives.
- ***Consistent with accountability.*** Part of meeting this criterion is ensuring that the level of government that decides on spending takes responsibility for raising money. This happens more consistently with property taxes than with income or sales taxes.

Tax Study Commissions

The experts' views are frequently echoed by the distinguished citizens who serve on state tax reform commissions, and legislators assigned to them or to make comparable studies. Two recent reports provide illustrations.

Ohio asked a blue-ribbon commission with heavy business representation to study its tax system, and the state gave it nearly a million dollars to do the job. While the group recommended reductions of some other taxes, it did not recommend reducing property taxes.[10] Instead, it concluded that more study was needed, but that the problem "is not with the level of property taxation." Its recommendations for dealing with the property tax problem it did find—complexity—would increase the base of the tax, causing property taxes to increase unless there were offsetting rate reductions.

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[9] There are extensive academic arguments, all supported by data, on these points. For policymakers, one aspect of these discussions is particularly salient. Looking at property taxes and household income at a single point in time and then looking over longer periods can produce different conclusions about regressivity. For example, when a family stays in one house for a lifetime, property taxes will appear high relative to income in the early working years and after retirement, but low relative to peak earning years. In a year of unemployment, property taxes will appear high, even if they are not high in relation to income over all years in the labor force. So the snapshot of all families taken at a single point in time may produce a different impression than the movie of a lifetime of receiving income and paying taxes. Most studies of regressivity of taxes, and thus the conventional wisdom, use the snapshot approach.

[10] Taxation And Economic Development In Ohio: A Blueprint For The Future, Report of the Commission to Study the Ohio Economy and Tax Structure (1994).

A tax reform study group in Georgia reported in 1995.[11] With many legislators on the commission, it bowed to pressures for property tax reduction:

> *The commission feels strongly that property taxes are too high and that some Georgia families feel an especially heavy burden. It also feels that the claims of education on public funds are likely to drive up property tax rates in the future.*

But the commission then concluded:

> *However, it is not possible to recommend a reduction in property taxes in this report.*

The commission found no similar barrier to other tax reduction proposals, recommending, for example, changes that would reduce revenues from the corporate income tax.

The Problem Is With The Alternatives

The property tax has proven resilient in the face of pressures for change, primarily because elected officials have often been more unhappy with alternative ways of raising revenue than they are unhappy with the property tax. Alternatives to raise equal amounts of revenues tend to have these flaws:

- The taxes offered to replace revenues have their own disadvantages.
- Change in relative reliance on particular taxes has economic costs that may be undesirable. An old economist's saw is, "An old tax is a good tax." The reason is that economic behavior will have adjusted to the old tax pattern, so significant changes will produce adaptive reshuffling in prices and consumer and investor behavior, with accompanying windfall gains and losses and non-productive expenditures on tax planning.
- Change probably has political cost beyond economic costs. Taxpayers will probably notice the increases more than the equal-dollar cuts. Opponents in elections will stress that an incumbent voted for a tax increase and will not add the magic words "in order to cut another tax by the same amount." Many voters will not believe that politicians did not sneak a tax increase into a supposed "revenue-neutral" plan. Voting for such a plan destroys the claims of incumbents that they did not vote for tax increases.
- The mechanics of replacing a local revenue source (some portion or all of local property taxes) with a state revenue creates major political and economic challenges. If the state does not replace both current and expected growth revenue, local officials will claim that they are being cheated. If the state replaces expected growth, it may worsen the state's fiscal position, because the state revenue might not grow as fast as the revenue replacement requirement. If state officials replace revenue loss dollar-for-dollar, they will have indefensible distributions, such as providing four or more times as much per capita to rich

[11] Joint Commission on Revenue Structure, Reforming The Georgia Tax Structure (1995).

jurisdictions as to poor ones. If they opt for a more "fair" distribution, state officials will face issues like those raised in changing school aid formulas.

State officials, of course, do not have to replace local revenue losses caused by state action to limit property tax levels, to reduce or eliminate assessments on favored property (e.g., business property, residential property), or slow the rate of growth in assessments. But to the extent that they do not replace revenue, state officials face new problems:

- Local officials can rightly complain that they are being forced to raise other taxes and/or cut spending as a result of state action.
- Groups that are potentially adversely affected by local spending cuts, such as teachers, will complain.
- Taxpayers who are potentially adversely affected by local compensating tax increases, such as businesses for homeowner tax cuts and homeowners for business tax cuts, will complain.
- Old disparities between spending needs (e.g., number of pupils) and tax base will be replaced by new disparities associated with the new tax base.
- Unless the legislation is skillfully drafted and the relevant provisions retained in the face of fierce opposition, the state budget will automatically pay much of the cost of revenue losses when the effects of property tax reductions work through the school aid formula.

Some State Officials Want More Spending

Though perhaps not a majority, a significant number of state elected officials do not like the idea of reducing any major source of state and local revenue, because they see the challenge as raising more or, at least, protecting existing revenues in order to pay for what they consider to be worthwhile spending. Another significant group sees dark clouds on the fiscal horizon in the form of recession, federal aid cuts, mounting costs for corrections and Medicaid, rising school enrollments, etc. They want to avoid state commitments to replace revenue losses from property tax cuts, because they fear that this would force unacceptable state tax increases or spending cuts in the future.

Many Tax Cut Priorities Are Different

While nearly every state elected official wants lower property taxes, many are committed to other forms of tax-cutting first. These tax relief priorities tend to crowd out any interest in allowing revenue losses from property tax cuts. For example, many governors and legislators (e.g., those in California, Connecticut, New Jersey, New York) are committed to sizable reductions in personal income taxes. In other states (e.g., Massachusetts, Pennsylvania), there is strong commitment to reduction of business taxes in the name of economic development, with business property taxes lower on this list than reductions in corporate income taxes.

WHAT'S HAPPENING IN THE STATES

Developments in 1995 provide a reasonable indication of the range of options available to state officials in dealing with property tax issues. This pattern—much talk about property tax

reduction and little action—is likely to persist into 1996 until there is a major change. The most predictable change is recession, which would so worsen state fiscal positions that talk of tax cuts would be muted. A similar effect could occur through significant reductions in federal funding unaccompanied by reductions in federal mandates that require state and local spending. These were some of the significant developments in 1995:

- **The concept of raising some state tax(es) to lower local property taxes lost badly.** At the beginning of the year, many state officials were studying ways to duplicate Michigan's dramatic lowering of property taxes by raising a state tax. By the end of legislative consideration of the issue in 1995, no state had done anything remotely resembling the Michigan action. South Dakota bought down local taxes with state revenue increases, including increasing the state take from video lotteries, extending the sales tax to additional services and goods, and a cigarette tax increase. Some key state officials who had expressed some interest in the concept in the past (e.g., the governors of Colorado, Ohio, Oregon, and Wisconsin, and the highest-ranking Democrat in Texas) were not buying into the concept in 1995.
- **The concept of using the growth of existing state revenue sources, without state tax increases, to relieve property taxes won a few local battles, but lost overall.** The most significant victories for this concept were in Utah (which lowered its state-imposed low-rate property tax) and in South Carolina and Wisconsin. Both those states used state revenues to lower property taxes, and elected officials committed with varying degrees of formality to continue the practice toward some end, such as the phase-out of property taxes for school operating costs in Wisconsin. Whether these objectives will be reached depends upon: (1) future affordability; and (2) whether, if an objective is not affordable with existing revenues, state officials will raise state taxes to achieve it.

  The giant losses for the concept occurred in the many states that used available state revenues and balances and committed substantial chunks of future revenue growth to the reduction of taxes other than property taxes. Many states did this in the form of phased reductions in personal income taxes, reductions in other state and/or local taxes,[12] and corporate tax reductions.
- **The idea of increasing state aid to local governments to encourage slower growth in property taxes had a mixed year.** Many states—particularly in the South, Midwest, and Mountain West—were in a strong fiscal condition when they adopted their FY 1996 budgets. One result was often school aid increases that exceeded what would be required to meet the state's current share of cost increases associated with the combination of inflation and enrollment growth.

[12] Among the local tax reductions were some specialized levies that are technically property taxes but which are not the primary interest of readers of this paper—for examples, motor vehicle taxes based on vehicle value and intangibles taxes.

However, this did not happen in the Northeast, where state officials were under more fiscal pressure and some were cutting state taxes.

There were a few new cases of state assumption of previously local functions (e.g., certain forms of mental health spending in Iowa), accompanied by some shifts in the other direction in California. None of the proposed big-ticket local-to-state shifts—like Medicaid in New York—were enacted.

- **Many states chipped away at the local property tax base without providing replacement revenues.** This was a particularly strong year for state decisions that reduced the local property tax base and/or provided increased authority for local governments to do so. Examples are state-mandated exemptions or lowered assessment ratios for business personal property (inventory, machinery and equipment, R&D equipment), expanded enterprise zones, and new flexibility for offering local tax abatements.
- **There was some activity on extending or enacting state limits on local property taxes and reducing state mandates that cause state and local spending.** Both these policies are backhanded ways for state officials to assert that they have done something about property taxes. Limits were tightened in a few states, such as Illinois, but apparently loosened in others.[13]

  Reducing state mandates that drive up local governments' costs (and thus presumably their property taxes) was discussed in many states. Much of the attention focused on labor-oriented issues—mandatory compulsory arbitration, state-mandated pension benefit increases, prevailing wages on local construction, and the like. Local government managements won and labor lost a few of these, but the big winner was the status quo.

  Outside of labor issues, there were some big issues for local flexibility. Counties in California and Wisconsin gained new flexibility to cut social and/or health programs. Local school districts got a comprehensive education reform bill in Texas, mostly oriented to ending state rules. A similar bill failed in California. In other states, governors and legislatures cut state department of education staffs and funding, made piecemeal changes increasing the authority of school districts, and beat up so much on state education bureaucracies that local flexibility has probably increased without either legal or budget changes.
- **Some states deliberately increased local property tax burdens, while others pursued policies likely to cause increases.** Subtle changes in school finance are occurring throughout the country which are causing local property taxes for schools to rise. Some whole reform plans—like the one in Texas and the one enacted this year in Alabama—cause this result fairly directly. It is caused

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[13] For an up-to-date compilation of limits, see the Advisory Commission on Intergovernmental Relations' Tax And Expenditure Limits On Local Government (1995). To make a long story short, because of exemptions (e.g., debt service, mandates, enrollment growth, and more), waivers permitted by public vote or extraordinary majorities, and details of how exactly the base is calculated, some limits are more limiting than others.

indirectly as states revise their school aid formulas to promote greater equalization among districts of differing wealth. Two common consequences are: (1) increasing property taxes in high-wealth districts as they attempt to maintain high school spending with frozen or declining state aid, and (2) increasing property taxes in low-tax-rate districts as states make the equalizing move of raising the assumed local taxes to be deducted from "foundation" spending to calculate state aid. Many states require all districts to levy at least this rate to qualify for any state formula aid.

- **Some legislatures and governors talked all year about tax reduction, not quite ever deciding whether the right choice was cutting the income tax, cutting property taxes, cutting some other tax, or a mixture of these.** Iowa will revisit this issue next year after a commission looks at the choices and makes recommendations. Georgia passed a hastily crafted compromise which the attorney general ruled was unconstitutional, so Georgia will also revisit the issue next year.

SHOULD RELIANCE ON PROPERTY TAXES BE REDUCED?

Introduction

Discussions of the property tax usually embody what Scott Mackey, the National Conference of State Legislatures' (NCSL) expert on property taxes calls "all of the cross-currents swirling around the property tax." Those cross-currents involve such issues as: (1) whether governments should spend less or more; (2) the division of responsibility between state and local governments; (3) how much should be spent on education relative to other functions; (4) achieving equalization among local governments of varying tax bases and spending needs; (5) the role of tax policy in economic development; and the (6) appropriate share of burdens between the rich and less rich, the young and the old, and business and households. With all of these policies in play at once, it is nearly impossible for either experts or elected officials to consider property tax policy rigorously and systematically.

To bring focus to the discussion, this section concentrates on the overriding tax policy issue involved: should the percentage of state and local tax revenue raised by taxes include a larger or smaller percentage of revenue from property taxes than it does today?

This focus narrows the issue because it excludes: (1) issues of fiscal policy broader than tax policy, such as how much government should spend; (2) cross-cutting tax issues that are best addressed by considering all taxes together, not just one tax, such as state-local divisions of responsibility, progressivity of tax burdens, and the role of tax policy in economic development; and (3) issues in the design and administration of the property tax—that is, given that property taxes will be raised, how the tax can best be administered and how the burdens can best be allocated among particular groups of taxpayers.

Comparing Property Tax Burdens

Whether to reduce property taxes is clearly a judgment for legislators and governors to make. However, there are some objective ways to measure whether property tax reductions are likely to be attractive, given the other alternatives.

No one argues that each state should make its policies the exact average of the policies of the other states as reflected in the national average. But considerable information about policy choices and a state's own policies can be gleaned from comparisons with other states. For property tax burdens, the best single measure is the percentage of personal income taken by property taxes in each state, as shown in the following table.[14]

Property Taxes as Percentage of Personal Income, 1992

Rank	State	Percent	Rank	State	Percent
1	New Hampshire	6.24	26	North Dakota	3.41
2	Wyoming	5.92	27	Indiana	3.34
3	Vermont	5.34	28	Virginia	3.28
4	New York	5.26	29	California	3.26
5	Arkansas	5.23	30	Ohio	3.22
6	Michigan	5.13	31	Utah	3.22
7	Oregon	5.00	32	Georgia	3.17
8	New Jersey	4.98	33	Pennsylvania	3.16
9	Rhode Island	4.90	34	Idaho	2.99
10	Maine	4.72	35	Maryland	2.98
11	Wisconsin	4.62	36	South Carolina	2.95
12	Montana	4.59	37	Mississippi	2.70
13	Connecticut	4.58	38	Nevada	2.57
14	Texas	4.32	39	Hawaii	2.30
15	Arizona	4.15	40	Missouri	2.26
16	Nebraska	4.14	41	North Carolina	2.25
17	Iowa	4.13	42	Tennessee	2.14
18	Illinois	4.12	43	West Virginia	2.06
19	Minnesota	4.10	44	Kentucky	1.92
20	Kansas	4.00	45	Louisiana	1.85
21	Florida	3.95	46	Arkansas	1.80
22	South Dakota	3.84	47	Delaware	1.60
23	Massachusetts	3.81	48	Oklahoma	1.58
	United States	**3.71**	49	New Mexico	1.52
24	Washington	3.58	50	Alabama	1.14
25	Colorado	3.57			

The table shows enormous variation among the states. New Hampshire property taxes are twice as high as those of a third of the states. Taxes in the highest 20 states are double or

[14] The table comes from States In Profile (1995 edition), Table D-4. It is drawn from the Census Bureau's Government Finances: 1991-1992 (Preliminary). These are the most recent data available with state-by-state detail.

more those in the lowest seven states. Alabama's property tax burdens are less than a third of the national average.

Eliminating Low Property Tax States

Using this table, states can be screened to determine whether the arguments for lowering property taxes seem to make sense in a national context. One line can be drawn arbitrarily at states where burdens are less than 2.71 percent of personal income, 1 percentage point below the national average. Put another way, these states could *increase* property taxes by 1 percent of everyone's income or more in most cases and still have property tax burdens below the national average. It would be surprising to see property tax cuts as a priority in these states. It generally has not been. For example, Mississippi voters will select a governor this year between two candidates, one of whom wants to cut the sales tax while the other wants to cut the personal income tax. Several of these 14 states cut taxes this year, but did not choose to cut property taxes. Tax studies in these states often suggest *raising* property taxes. This has already happened in Alabama and for some taxpayers in Arkansas, is high on the agenda in Louisiana, and is a popular idea in metropolitan areas in New Mexico.

Minnesota's action this year suggests the forces at work. The regular legislative session ran into its constitutional limit on session length before legislators could agree on a school aid formula. In special summer session, they found that higher local school taxes were the keys to unlocking the solution. The resulting compromise was approved by overwhelming margins in both houses, with much of the debate centering on whether it meant that the governor and some legislators had broken their no-new-tax pledges—but not on whether the increase was a good idea.

North Dakota's action illustrates what motivates state legislators to cause local property taxes to increase. Property tax reliance is unpopular there for all the usual reasons, exacerbated by above-average school finance disparities resulting from the large number of small school districts.

A bipartisan group of legislators offered one standard remedy—increasing state sales or income taxes (they chose both) to provide a large new increment of state school aid that would be used to buy more equalization among school districts and reduce school property taxes. This failed because many legislators refused to consider increases in state taxes, and even tax supporters feared a repeat of 1989, when North Dakota voters used referendum procedures to take a legislated tax measure to voters who repealed it.

The state education agency, and others, had another obvious alternative—giving local school districts the option of enacting local sales or income taxes (they chose income taxes), with the proceeds being used for reducing property taxes and school spending. This alternative, a perpetual favorite but never quite a winner, also presents problems, not the least of which are administrative costs and complexity, and creating new disparities in tax base per pupil.

With these options off the table and a statewide property tax prohibited by the constitution, North Dakota legislators needed a way to promote equalization. So they raised what they call the "mill levy deduction" in the school formula. This device is so technical that

few people understand it. People knowledgeable about school finance like it because it does not raise state costs beyond what legislators are already prepared to spend, makes state aid increases appear larger than they are, increases total school spending, does not increase state taxes nor make state officials accountable for local tax increases, and provides considerable equalization in school finance—thereby relieving pressures from courts and officials and taxpayers of low-wealth school districts. A long footnote[15] explains the basics. This type of change tends to appear in state budget and school finance bills as a last-minute compromise, so many legislators are not fully aware of its impact in encouraging local property tax increases.

Eliminating States That Have Already Dealt With High Property Taxes

Three states have made major revisions in their tax systems that should result in much lower property tax burdens when data become available for 1995. Michigan dramatically lowered property taxes by dramatically increasing sales taxes. Connecticut adopted a personal income tax and used some of the revenue for property tax relief. Kansas raised several state taxes to increase the state share of school costs and reduce property taxes.

Eliminating States With Extraordinarily High And Low Tax Burdens

Alaska and Wyoming have fabulous natural resources in relation to their populations. As a result, these states have extraordinarily low tax burdens on households despite high per capita spending. Alaska has no state sales or personal income tax, and gives each citizen about $1,000 a year just for living there. Wyoming has no personal income tax. Property taxes are not major problems in these states. They appear as high property tax states on the

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[15] The typical state school aid formula is often called a "foundation" formula because it calculates a foundation or minimum amount of per pupil spending and guarantees each district that amount (minimum per pupil times number of pupils in the district). The district's share is the amount that a state-stipulated property tax rate, known as a minimum or qualifying levy in most states, raises when applied to the tax base in that district. The state pays the rest. So the local share is a deduction from what the state otherwise has to pay, which is why North Dakota calls it the mill levy deduction.

North Dakota raised this tax rate dramatically, from 24 to 32 mills, over two years. This increases dramatically the local share of paying for the foundation minimum. It is equalizing because it raises the per pupil amount of the deduction much more in rich districts than in poor ones. It also reduces the state aid costs dramatically, which the state gives back by raising the foundation level of per pupil spending, which is also equalizing. In the average district, the effect is a wash. What the district loses in additional local contribution, it gets back in a higher guaranteed minimum spending. But rich districts lose state aid. While the loss is often prevented by hold harmless provisions, such districts must raise taxes locally to cover the full costs of inflation, enrollment increases, and any enrichment they want. Poor districts get big increases in state aid, which reduces the need for higher property taxes. But many poor and some average districts will have a lower property tax rate than the new state rate. In some states, they must raise their rate to qualify for any state aid. In others, they raise taxes on their own initiative because state aid is reduced if they fail to make the stipulated local tax effort.

table only because they collect massive revenues on natural resources that the Census Bureau classifies as property taxes.

Some states have high property taxes because they have high state and local spending. Even if they match the national average balance in the use of property and other taxes, they will continue to have high property taxes. Many people in these states think that this is a problem; some blame high property taxes, some blame high income taxes, and some blame other taxes. If there is a problem in these states, it is not so much a tax policy problem as a tax and spending level problem. New York comes off the property tax reform list for this reason. It got about 33.3 percent of its state and local tax revenue from property taxes in 1992, almost the same as the national average of 32.1 percent. But its total state and local tax burden was 15.8 percent of personal income, well above the national average of 11.5 percent.

No other states were excluded from the list of candidates for property tax reduction because of this factor, but arguably the focus of their officials who want to lower property taxes should be on controlling spending, not trying to juggle the resulting tax burden among taxpayers. The close-call candidates (and their taxes as a percentage of personal income)[16] are Hawaii (14.1%), Minnesota (13.1%), Wisconsin (13.1%), and Vermont (12.8%).

Dealing With The "Missing Tax"

Some of these states have high property taxes because no amount of feasible restraint on public spending overcomes the revenue impact of not having a personal income tax or a sales tax. New Hampshire, which has neither tax, is a good example. In these states, all other taxes tend to be higher, not just the property tax. The issues are pretty well understood locally and debated constantly and intensely. In these states, property tax reform and reduction are best handled exactly the way state officials and citizens are now considering the subject, as part of broader tax reform issues.

The ranks of states that are candidates for discussion of property tax reform and reduction were thinned by eliminating these states (and their missing tax): #1 in property tax burden New Hampshire (no sales or income tax), #7 Oregon (sales), #12 Montana (sales), #14 Texas (income), #21 Florida (income), #22 South Dakota (income), and #24 Washington (income).

Property Tax Reduction Candidates

With these exclusions, 23 states, less than half, remain as reasonable candidates for places where state officials might seriously want to consider following the examples of Michigan (raising a state tax to lower property taxes) or Wisconsin and South Carolina (lowering property taxes a little and promising to do more without raising state taxes). These states are shown in the following table. Notice that only four of the ten states with the highest property taxes remain on the list.

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[16] Data from Table D-1 of Profile (see note 14).

Property Taxes Percentage of Personal Income, 1992 States that are Reasonably Serious Candidates for Property Tax Reduction					
Rank	**State**	**Percent**	**Rank**	**State**	**Percent**
3	Vermont♣	5.34	26	North Dakota♦	3.41
8	New Jersey♥	4.98	27	Indiana♦	3.34
9	Rhode Island♣	4.90	28	Virginia♥♦	3.28
10	Maine	4.72	29	California♣♥♦	3.26
11	Wisconsin	4.62	30	Ohio♦	3.22
15	Arizona♥	4.15	31	Utah♦	3.22
16	Nebraska	4.14	32	Georgia♦	3.17
17	Iowa	4.13	33	Pennsylvania♥♦	3.16
18	Illinois	4.12	34	Idaho♦	2.99
19	Minnesota	4.10	35	Maryland♥♦	2.98
23	Massachusetts♥	3.81	36	South Carolina♦	2.95
25	Colorado♦	3.57			

Beside the state names there are symbols for three good reasons why a state remaining on the list might not opt for property tax reductions paid for with state taxes.

Some states are already in such poor fiscal condition that they are scrambling to avoid tax increases just to fund existing programs, making a new costly plan to lower property taxes pretty much dead and buried (♣). Many observers—including Steven Gold of the Urban Institute, State Budget & Tax News, and leaders and staff of NCSL—have warned that many additional states will soon be in this position.

Some states have governors and/or large blocks of legislators clearly committed to reducing some other tax (♥), such as the income tax in New Jersey, Arizona, and California. Over half the states have property tax burdens below the national average (♦), making lowering property taxes a somewhat lower political and economic priority than in the other states listed.

Eliminating all these states leaves a truly short list.

Property Taxes as a Percentage of Personal Income, 1992 States That are the Most Serious Candidates for Property Tax Reform		
Rank	**State**	**Percent**
10	Maine	4.72
11	Wisconsin	4.62
16	Nebraska	4.14
17	Iowa	4.13
18	Illinois	4.12
19	Minnesota	4.10

In these six states, there are somewhat differing situations. Wisconsin officials have started reducing property taxes, and plan further reductions through a combination of policies, including cutting state pressures on local spending by mandate elimination, cutting local authority to raise property taxes by state-imposed limits, and using state revenue growth to reduce property tax needs for school finance. Minnesota officials are cautious about any massive plan increasing state commitments because they, more than most, fear future budget imbalances. Maine officials have the same fear and have already adopted a compromise approach on tax policy this year that will be hard to finance in the future. Iowa officials argued about what tax to cut this year and will argue the issue again next year. In Nebraska, the issue of reducing property taxes is closely tied to controversial issues of school finance equalization and consolidating tiny school districts. Illinois officials have rejected the alternative that state officials of both parties have urged for years—increasing the low flat rate income tax to reduce reliance on property taxes—and state finances are in such bad shape that growth from existing revenues will be used for other purposes.

Two conclusions follow from this state-by-state analysis. First, there are some reasonably good reasons why officials of most states are not cutting property taxes. Second, state officials should not worry much that they will miss out on a wave of state-financed property tax reductions sweeping the country.

IMPROVING THE PROPERTY TAX

These conclusions suggest that elected officials of most states will continue to rely heavily, and perhaps more, on property taxes than they do today, despite the many public criticisms of the tax and often despite their own determination and pledges to reduce property taxes. This awkward result suggests that elected officials will find considerable merit in policies that reduce the apparent disadvantages of property taxes while not relying less on them for revenues.

Fortunately, this is an area where experts and tax administrators are in fundamental agreement about appropriate public policy. There are many comprehensive guides to reforms that deal with the perceived problems of property taxes without reducing property tax revenues. A sampling of these appears in the notes at the end of this paper.[17] The advice

[17] The definitive policy-oriented work on improving property taxes is now over three decades old. In the intervening 30+ years, many states have adopted reforms recommended in the Advisory Commission on Intergovernmental Relations' The Role Of The States In Strengthening The Property Tax (1963). The results suggest that the reforms do work. Transitions are inherently difficult because they alter the distribution of tax burdens among taxpayers and involve getting large numbers of local assessors to march to the beat of the same drum.

For elected officials, NCSL provides a continuing source of expertise on ways to improve property tax administration, examples of states that have accomplished reforms, and recent trends and developments. There are many useful NCSL publications on these subjects, such as State Property Tax Relief Programs For Homeowners and Renters (1992), How States Limit City And County Property Taxes And Spending (1992), Reforming State Tax Systems (1986), The Unfinished Agenda For State Tax Reform (1988), and Reforming State-Local Relations: A Practical Guide (1989). NCSL's recent State Tax Policy & Senior Citizens (1995)

of state experts to elected officials is briefly summarized in the chapter on property taxes in Financing State Government In The 1990s, a joint effort of NCSL, the National Governors' Association, the Federation of Tax Administrators, the Multistate Tax Commission, and the National Association of State Budget Officers.

The recommendations include administrative improvements such as assessments at full market value, improved training of local assessors, and frequent reassessment. They also include devices to relieve the burdens of property taxes in cases where they are often perceived as unfair, such as targeting relief to persons with low incomes and high property taxes, and collecting property taxes on elderly persons who feel burdened by them from their heirs by allowing tax payments to be deferred. There are also many recommendations for dealing with fiscal disparities among local taxing units.

Handling Property Tax Issues In Legislatures

The substance of expert recommendations puts elected officials at risk through many apparently unpopular moves. These include: (1) saying "no" to many groups seeking special treatment; (2) raising property taxes of some taxpayers and reducing those of others in the name of fairness; (3) helping poor jurisdictions by in effect redistributing money from local taxes in rich jurisdictions; and (4) in some states, paying for reductions in property taxes by voting for new or increased taxes on sales or personal income.

Elected officials are understandably and appropriately wary of recommendations by unelected staff members and experts on how to make unpopular policies more politically palatable. For what they may be worth, a collection of such recommendations appears as Attachment B to this paper.

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assesses attempts to target property tax relief to older Americans in the context of relief provided this group through other taxes. Associations of officials responsible for property taxes have published handbooks, standards, and studies such as the International Association of Assessing Officers' Property Tax Appraisal And Assessment Administration (1990) and Standard On Ratio Studies (1990).

Academics have also made useful contributions which have remained consistent for decades. See, for example, A. D. Lynn, ed., The Property Tax And Its Administration (University of Wisconsin Press, 1969), and G. E. Peterson, ed., Property Tax Reform (Urban Institute, 1973). For more recent academic contributions, see, for example, R. J. Hy and W. L. Waugh, eds., State And Local Tax Policies (Greenwood Press, 1995), and J. Bowman, ed., Taxation Of Business Property (Greenwood Press, 1995).

Many states have several old, but unimplemented, reports on reforming property tax administration. For an example of a new report of this type, see the Rhode Island Public Expenditure Council report Modernizing The Property Tax: An Issue Of Fairness (1995). New reports are constantly being commissioned. For example, this year Oklahoma passed legislation creating an advisory task force on property taxation, with 30 members to be appointed by the governor and leaders of the House and Senate.

ATTACHMENT A: BUSINESS AND THE PROPERTY TAX

This paper is mostly about property taxes paid directly or indirectly by households, particularly the residential property tax (including taxes levied on apartment and other rental property owners), not about taxes on property used for business.[18] This emphasis was chosen for two reasons: (1) most of the interest in property tax reduction and most of the perceived unfairness of the property tax are focused on residential property taxes; and (2) the tax policy considerations appropriate for business property relate to two broader and separable issues: (a) the appropriate reliance on taxes on businesses as distinct from households in the total (state and local) tax system of a state; and (b) appropriate ways to tax business. These topics are too broad for consideration in this paper. However, some summary observations are presented here because of the interaction of business and residential property tax issues.

Economic development considerations have their place in tax policy, but are relevant to only a portion of property taxes paid by business.

Some business activity is inherently local, including (outside of areas adjacent to another state) practically all retail sales, food services, most public utility services, property services that must be performed on-site (e.g. repair, remodeling, construction, janitorial services), health care, personal law and accounting, real estate, consumer banking, and much more. For these goods and services, state residents are selling and buying from each other. Giving some of them lower taxes may be a good idea for other reasons, but this can not stimulate economic development because it does not add any money to the state's economy.

State tax policy can just shift the burden around among residents—lowering one business' taxes may produce lower prices and stimulate demand for what it sells, but the consequences are higher taxes for other businesses (reducing what they can sell) and/or for households (reducing what they can buy) unless spending is cut, which is a separate issue.

Thus, if state officials are trying to buy economic development with lower taxes, they should only lower taxes on businesses that draw new money into the state's economy (or substitute for out-of-state sellers who are now taking money out of the state). This means, with minor exceptions, that the only appropriate reductions of business taxes relate to manufacturing, mining, agriculture, nationally oriented offices (e.g., corporate headquarters and R&D facilities, headquarters of national trade associations), and a small portion of service activities (e.g., investment banking, international consulting) that are oriented toward sales out of state.

As a result, sweeping business tax reductions—lowering business property taxes, exempting inventories, lowering the corporate income tax rate, eliminating certain sales taxes

[18] State officials appear to be recognizing the need for separate consideration of business property and other taxes in the context of economic development taxes and the impact of all state and local taxes on business rather than in the context of a particular tax, such as the property tax. For example, the interim study of tax reform by Iowa's legislative council has one group working on business taxes and another working on household taxes, which they call "nonbusiness taxes."

paid by business—are unnecessarily expensive. Most, but not all, states recognize this by confining economic development-oriented tax cuts to export-oriented firms. Such targeting takes many property tax proposals off the table as economic development, though not necessarily for other reasons. Some examples are: abatements for shopping centers and auto dealers, broad exemption of inventories, and exemptions of office machinery for all firms.

Business property taxes are usually the major culprit in causing fiscal disparities among local governments, particularly in school finance. They can often be more easily be attacked by property tax policy than by trying to force consolidation of local governments or by (usually expensive) attempts to buy school finance and other equalization with state money.

There are lots of ways for states to achieve their equalization objectives by altering rules for business property taxes. Some examples are: In Minnesota, business property taxes are shared among Minneapolis/St. Paul area governments. Michigan has adopted what amounts to a uniform statewide business property tax in its recent reforms. Mississippi dealt with a multibillion-dollar power plant in a tiny district by spreading property taxes over all jurisdictions whose residents got power from the plant. Not wanting to raise state taxes or consolidate school districts to get equalization, Texas gives its districts with high-value business property five options, including sharing their property tax revenues with other districts or agreeing to send surplus revenues to the state for distribution to poor school districts.

Although there may be political advantages, there is no significant economic advantage to be gained by taxing commercial rental residential property at higher rates than owner-occupied residential property.

Defining apartments as businesses and taxing rental property at a higher rate than owner-occupied property results in higher taxes for renters than comparable homeowners. There may be reasons for doing this, but the burden of the taxes will be borne by renters (with only minor transitional exceptions). Why? Because neither bankers who loan mortgage money nor investors with equity money need to give your residents any breaks; they can invest anywhere. So they will get about the same returns on their money in every state, and tax differentials will become rent differentials.[19]

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[19] State policies on property tax relief, such as credits against income taxes for excessive property taxes, sometimes presume that renters bear property tax burdens and sometimes do not. Experts generally assume full shifting of burdens of owner property taxes to renters. For example, the household tax burden model maintained by KPMG Peat Marwick—which has recently been used in tax policy studies in Kentucky, North Carolina, New York, and probably other states—assumes full shifting to renters. See, for example, the KPMG July 1995 report, Comparative Analysis Of Kentucky's Tax Structure, prepared for the Kentucky Commission on Tax Policy, p. 23.

Analysis of this study of 15, mostly Southern, states also shows that renters are often bearing higher property tax burdens (assuming that the landlord's property taxes are shifted) than owners. For example, on average the property taxes of the 15 states took 3.1 percent of

Many important business property tax issues are too unique to specific states and too complex for summary consideration.

Many state officials have looked for ways to maintain different tax rates for commercial, industrial, and residential property—generally with the objective of having property taxes that are a higher percentage of value for the business property. Some states (e.g., New York and Minnesota) can do this directly by differentials in assessment ratios or applicable tax rates. Some states attempt to achieve this result indirectly because their constitutions prohibit such differentials.

Interest in this subject is particularly intense recently because of two conflicting forces. In many jurisdictions, residential values have soared in relation to business property values, sharply increasing the percentage of property taxes paid by homeowners. This has happened in boom communities (e.g., Colorado, Utah) because of rapidly rising market values for residential property. It has also happened in declining communities (e.g., in the Northeast) as manufacturing firms close facilities or properly seek lower assessments associated with obsolete plants and machinery. One solution is to freeze the share of property taxes paid by business and residential property.

However, many states are trying to reduce property taxes on business in the name of economic development and competition, and are being forced by changes in these industries to try to reduce property taxes on previous monopolies in telephone, electric, and gas service.

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income of renter income of $20,000, but took between 2.3 percent and 2.8 percent of owner incomes in all the family income levels analyzed. Homeowners with $30,000 in income pay less property taxes than renters with $20,000 of income in Florida, Louisiana, and Mississippi, and pay almost the same, despite their 50 percent higher incomes, in Alabama and Illinois.

ATTACHMENT B: SOME SUGGESTED DOS AND DONT'S

As is often the case, it is the moderates and pragmatic decisionmakers who have the most problem finding an acceptable strategy, because they see merit in both sides of tax policy and other issues. For those who want dramatic reductions in government, tax policy is simple: attack each and every tax at every opportunity, seizing all opportunities for cuts wherever they arise. For those who really see few proposals for public spending they do not like, the strategy is the reverse. This advice is for the rest: those who do not like taxes, but recognize that maintaining about the current level of revenues is a necessary evil.

Do Defend Local Tax Bases

Economically and politically, the worst taxes are those with high rates. High rates magnify economic distortions; they encourage those affected to run to other states and communities; they allow people to criticize you for having higher taxes (that is, tax rates) than similar states; and they increase the possibility that you will have to deal with tax limits and, in the states that allow voter initiatives, with public votes on propositions to roll back certain taxes without any way to replace the revenue.

To avoid pressures for high rates, keep the tax base as broad as possible. Resist proposals to provide tax exemptions for particular worthy causes. Preventing government from coercively taking their money as taxes is a worthy cause for everyone, so try not to pick winners, because, by doing so, you are also causing losers.

Do Dramatize Your Problems With Proposals To Create New Loopholes By Insisting On Common-Sense Safeguards

Want to derail a tax exemption for all elderly, such as exemption of more pension income or property taxes? Insist on an amendment that says nobody can have an exemption who has income from all sources higher than the average citizen in your state, or, to be generous, more than 50 percent higher than the average person who will have to pay for this special tax benefit. And make sure that no exemptions are available for people with three times or more the net worth of the average household in your state, or, to be generous, insist that no one who is a millionaire be eligible. If you have a proposal to reduce property taxes on those with low incomes, just insist that only they be benefited by recapturing your revenue losses before property goes to heirs, or at least do this if the heirs are richer than the average taxpayer.

Do Not Get Sucked Into Discussions Of Tax Policy When The Issue Is Spending

People who think that you spend too much will criticize whatever taxes you levy. They will emphasize the tax least favored by the audience at the time. You will be tempted to talk about "fixing" the tax system to lower or eliminate that tax. But sooner or later, you will have to favor raising some other tax to make this possible. No matter how many fixes you make, the people who think that you spend too much will still think you tax too much. No matter how much you juggle taxes by raising one to cut another, you will end up with a tax system that is unfair from many perspectives and inherently unpopular. Furthermore, by juggling

taxes, even if you do not raise taxes, people will still think that you did. First, you did vote to raise taxes. Second, it is generally agreed that people notice the increases more than the cuts.

Of course, you can bob and weave, and minimize, if not escape, some of the heat. But if the problem is spending, then you really do want to use the coercive power of government to take involuntarily from people money they do not want to give to government. So if you do not want to defend the spending, cut it and then you can cut whatever taxes you choose. If you do want the spending, then defend the spending, say that nobody, including you, likes taxes, agree that you do not like the tax being criticized, say something bad about that tax to demonstrate your sincerity, and then say that you have looked at the alternatives. Name one or two, and say bad things about them. If you believe this, also say that you are skeptical about reforms that purport to enact a new tax or raise an old tax to relieve some other tax—because you worry that the tax raise will happen, but that the tax cut will not.

Do Seize Opportunities To Broaden The Tax Base

Broadening the base for any tax means raising taxes, so easy opportunities do not come along often, but there are a couple worth mentioning: (1) When the federal government limits deductions or eliminates some adjustments to income that lower state and federal taxes, do not rush to keep the old state rules. Follow such changes in the name of less paperwork for taxpayers and lower administrative costs for the state. Use the money for some popular spending increase or cut the tax rate. (2) When you or the media find an apparent abuse, leap to close the loophole in the name of fair taxation, using the support of the media and/or groups that are hurt.

For example: (1) for home-town merchants hurt and jobs lost by mail order sales, go for federal law changes, making it clear that you can tax all sales to customers in your state, and support legislation permitting your tax department to be aggressive in finding that you have jurisdiction over mail-order sellers; (2) it is unfair to stores that they must collect taxes on hair care products and paint for home use but that beauticians and house painters escape taxes on the same items, so go after a tax on painters and beauticians letting them exclude from sales tax only the portion of cost associated with their services; (3) for some businesses pitting community against community in locating shopping centers, auto dealerships, and similar local service businesses, tighten the law so that tax breaks for economic development are available only to businesses that sell most of their products out of state.

If you ever have to vote to raise taxes, go for the changes that make the base broader, rather than the rates higher. Do not raise sales tax rates unless you already tax consumer consumption purchases of nearly all goods and services like massage parlors, health clubs, veterinarians, lawn service companies, maid services, repair services, and others. Do not raise income taxes unless you already tax all income that the federal government does, including a portion of Social Security, private pensions, unemployment compensation and more. Meet objections that the needy are hurt, with credits targeted to poor people, instead of assuming, for example, that everyone getting a pension is poor. Do not raise property taxes until you make sure that assessments reflect recent property value increases and capture property held by tax-exempt entities but used for business purposes, and that

homestead exemptions (if you must have them at all) do not benefit rich taxpayers as well as poor ones.

If You Really Favor Tax Reform, Do Not Try For Consensus

Revenue-neutral tax reforms—such as raising sales or income taxes to lower property taxes—will help some taxpayers and hurt others. Before you commit to a plan, make sure through hearings and studies that you know who is being hurt and helped, and line up the winners to fight with you and do not quake and quiver in front of the losers. Do not say that you did not realize they would be hurt and that you will try to find a way to fix it—your fixes will only hurt somebody else, further reducing your support and enhancing your opposition. Most people you try to help this way will never know that you fixed it, because the dynamics of interest group opposition means that once a group is opposed, it cannot easily turn around its members to match gyrations in your plan.

An outstanding example of what not to do appears in the fiscal history of Oregon. Oregon property taxes and personal income taxes are much higher than those in most states and higher than those in Oregon's neighbors. The reason is simple: Oregon never adopted a sales tax. Why not? Of course there are valid objections, including the fact that sales taxes are regressive and that merchants in border areas are better off with low taxes than high ones. But these were valid objections in all the states that adopted sales taxes. Every expert, inside and outside Oregon, believes that Oregon would be better off with a sales tax and lower property taxes, and maybe even lower income taxes—though of course there is no agreement on whether overall Oregon governments should spend less or more. Nearly every civil leader, business leader, and elected official understands the situation. This is why Oregon legislators have put a sales tax to a popular vote eight or nine times over six decades.

They have been turned down every time. Most recently, the then-governor spent over a year looking for "consensus" on what to do, which she did not get. Failing that and faced with a successful initiative from voters fed up with property taxes who enacted a rollback by initiative, she tried last-minute leadership and proposed a hastily concocted plan. Legislators put it on the ballot, but many elected officials shied away from it—both out of concern with how it was drafted and out of recognition that it probably would not pass, given the lack of a political push for it before the vote. It predictably failed, school funding has been squeezed hard, and property taxpayers have watched their bills soar as assessed value increases defeated the objective of the rate cap.

Contrast three property reduction plans—two that passed and one that will not be endorsed until it is ready to pass.

One which I was associated with, was the enactment of new corporate and personal income taxes by the Ohio legislature in 1970 and their subsequent approval by voters in 1971. Nearly everyone agreed at the time that the state would have to raise the sales tax and that property taxes would rise if there were no income tax. The promise of property tax relief was simple, though inelegant (an immediate 10 percent reduction for everybody). And proponents looked those who would pay more in the eye, told them that their taxes would go up, and explained why they should support the plan anyway.

The second was Michigan, where voters consistently turned down proposals to lower property taxes by raising some other tax, but kept complaining about excessive property taxes. Finally, Michigan's elected officials bit the bullet and decided that they would raise state taxes and lower property taxes, but gave voters a choice about whether to raise the sales tax or the income tax. Nearly everyone now seems reasonably happy. Voters and business have lower property taxes; sales taxes are higher, but many voters probably think that they did it to themselves; and most elected officials are bragging about what they did.

My third example has not happened yet. Texans seem to have world-class aspirations for their schools, universities, infrastructure, and economic development, but cannot support them with oil and gas revenues anymore. So sales taxes have soared to nearly 10 percent of combined state and local rates in many areas. Property taxes have also been rising rapidly. Elected in 1994 on a platform that included rolling back reliance on property taxes for financing schools, Governor Bush had a successful legislative session in 1995, achieving his four objectives for the session, but making decisions that will cause sales taxes and property taxes to continue to rise.

On a substantive level, the governor and legislature did something stupid this year. They authorized another tax study, one bound to find what a fine tax study recently found and bound to tell elected officials what they already know, that they have to do something that looks suspiciously like an income tax if they will not curtail spending, do not want rising sales and property taxes, and, above all, if they want to roll back school property taxes. On a political level, they are cleverly waiting for the situation where Texas leaders as a block will, with the support of many business and civil leaders and interest groups, look Texans in the eye and deliver the bad news.

THE FINANCE PROJECT

The Finance Project is a national initiative to improve the effectiveness, efficiency, and equity of public financing for education and other children's services. With leadership and support from a consortium of private foundations, The Finance Project was established as an independent nonprofit organization, located in Washington, DC. Over a three-year period that began in January 1994, the project is undertaking an ambitious array of policy research and development activities, as well as policymaker forums and public education activities.

Specific activities are aimed at increasing knowledge and strengthening the nation's capability to implement promising strategies for generating public resources and improving public investments in children and their families, including:

- examining the ways in which governments at all levels finance public education and other supports and services for children (age 0-18) and their families;
- identifying and highlighting structural and regulatory barriers that impede the effectiveness of programs, institutions, and services, as well as other public investments, aimed at creating and sustaining the conditions and opportunities for children's successful growth and development;
- outlining the nature and characteristics of financing strategies and related structural and administrative arrangements that are important to support improvements in education and other children's services;
- identifying promising approaches for implementing these financing strategies at the federal, state and local levels and assessing their costs, benefits, and feasibility;
- highlighting the necessary steps and cost requirements of converting to new financing strategies; and
- strengthening intellectual, technical, and political capability to initiate major long-term reform and restructuring of public financing systems, as well as interim steps to overcome inefficiencies and inequities within current systems.

The Finance Project is expected to extend the work of many other organizations and blue-ribbon groups that have presented bold agendas for improving supports and services for children and families. It is creating the vision for a more rational approach to generating and investing public resources in education and other children's services. It is also developing policy options and tools to actively foster positive change through broad-based systemic reform, as well as more incremental steps to improve current financing systems.

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